

TAB E

**BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554**

In the Matter of)	
)	
Application by BellSouth Corporation,)	
for Authorization To Provide In-Region,)	WC Docket No. 02-307
InterLATA Services in the)	
States of Florida and Tennessee)	

**DECLARATION OF JOHN C. KLINK AND BRIAN F. PITKIN
ON BEHALF OF AT&T CORP.**

I. QUALIFICATIONS AND SUMMARY

1. My name is John C. Klick. I am a Senior Managing Director of the Network Industries Strategies group at FTI Consulting, Inc. My offices are located at 1201 I Street, N.W., Suite 400, Washington, D.C. 20005. I have provided testimony before federal and state courts, arbitration panels, the Surface Transportation Board (and its predecessor, the Interstate Commerce Commission), the Federal Communications Commission, the Federal Energy Regulatory Commission, numerous state regulatory agencies, and mediators. During the past six years, many of my consulting engagements have involved economic and pricing issues arising out of the Telecommunications Act of 1996. I have provided testimony in numerous states on TELRIC models, including the HAI Model (and its predecessors), the BCPM, the Hybrid Cost Model, and the FCC's Synthesis Model. I have also testified extensively on collocation and line sharing. In part, this testimony has relied upon lessons learned in consulting engagements in other network industries such as railroad transportation, pipeline transportation, and energy. I have

lectured on economic issues to various technical trade groups, and have taught a well-received Consulting Practicum as part of Georgetown University's MBA program.

2. My name is Brian F. Pitkin. I am a Director in the Financial Consulting Division of FTI Consulting, Inc. During the past six years, I have had extensive experience with the cost models and underlying databases that have been submitted in proceedings arising out of the Telecommunications Act of 1996 ("1996 Act"). I have testified on the inputs and methodologies used in a variety of cost models and cost studies used in state and federal proceedings for estimating costs of (1) unbundled network elements ("UNEs") for interconnection, (2) basic local service for universal service fund ("USF") requirements, and (3) access services. I received a Bachelor of Science degree in Commerce, with concentrations in both Finance and Management Information Systems, from the McIntire School of Commerce at the University of Virginia in 1993. I participated in the Florida UNE ratemaking proceeding and testified on behalf of AT&T and WorldCom.

3. The purpose of our testimony is to discuss the cost overstatement that arises -- in the establishment of UNE rates -- from a double-count of inflation that is inherent in the BellSouth procedures that have been accepted by the Florida Commission. This double-count was well documented in the Florida proceedings establishing the current UNE rates, and the Florida Commission erred in reaching its conclusions.¹ Moreover, this is not a matter of opinion or

¹ See Rebuttal Testimony of John C. Donovan and Brian F. Pitkin on Behalf of AT&T Communications of the Southern States, Inc. and MCI WorldCom Before the Florida Public Service Commission, Docket No. 990649-TP, July 31, 2000, pages 16-24; Supplemental Rebuttal Testimony of Brian F. Pitkin on Behalf of AT&T Communications of the Southern States, Inc. and MCI WorldCom Inc. Before the Florida Public Service Commission, Docket No. 990649A-TP, February 11, 2002, pages 2-11. The Florida Commission in its order on reconsideration reversed a prior ruling and adopted BellSouth's position on the inflation factor, stating "[w]e find that it is important for us to reconsider our decision regarding the inflation factor at this time,

interpretation, but is a matter of mathematics. Both inflating material prices into the future and including inflation in the cost of capital results in a double-recovery of inflation.

II. EXPLANATION OF INFLATION DOUBLE-COUNT.

4. The inflation double-count in the UNE rates adopted by the Florida Commission occurs because (1) the cost of capital utilized by the Commission is derived in a way that compensates BellSouth for the effects of inflation, and (2) that cost of capital is applied to per-line asset values that are assumed to inflate each year during the three-year “planning horizon” relied upon by BellSouth. This impermissibly permits BellSouth to recover the costs of inflation twice, and serves to overstate the cost-based price of UNEs.

5. The potential for this sort of double-count is well-established in the economic and financial literature. Included as Attachments 1 and 2 are two articles, dating from the mid-1980s, in which the authors demonstrate that there are two alternatives for compensating investors (such as BellSouth’s investors) for inflation. One method includes the effects of inflation in the cost of capital, and applies that cost of capital to historical asset values. The other excludes the effects of inflation from the cost of capital, and reflects the effects of inflation instead in the increasing value of the asset base over time.

6. The first cost of capital (*i.e.* the cost of capital that compensates investors for inflation) is known as the “nominal” cost of capital; the cost of capital that excludes the effects of

rather than as a part of the 120-day filing, due to the significant impact that the inflation factor has on costs.” Order on Motions for Reconsideration and Motion to Conform Analysis, In re: Investigation Into Pricing of Unbundled Network Elements, Docket No. 990649-TP, Order No. PSC-01-2051-FOF-TP, October 18, 2001, page 5. The 120 day order includes a discussion of the effects of inflation for engineering costs, which gives rise to the triple-counting of inflation discussed at ¶ 16 *infra*. Final Order on Rates for Unbundled Network Elements Provided by BellSouth Telecommunications, Inc. (120-Day Filing In re: Investigation into pricing of

inflation is known as the “real” cost of capital. What these academic articles make clear is that it would be inappropriate to apply both a nominal cost of capital and to reflect the effects of inflation by increasing the value of the asset base over time.

7. The need to ensure against this form of inflation double-count has also been addressed by regulators. In our view, the clearest discussion of this issue in a regulatory context is in the September 1, 1987 Final Report of the Railway Accounting Principles Board (“RAPB”), a body empowered by Congress “(1) to establish a body of cost accounting principles to serve as the framework for implementing the regulatory provisions in which cost determination plays a vital role, and (2) to make administrative and legislative recommendations it deems necessary to integrate the principles into the regulatory process.” In its Final Report, the RAPB explained these two alternative methods of accounting for inflation as follows:

Current Nominal Cost of Capital

This alternative is currently used by the ICC [Interstate Commerce Commission]. It differs from traditional cost of capital in that the opportunity cost concept is applied to debt as well as equity. Debt is measured at current cost, that is, at the return currently expected by the bondholders and other creditors. Equity is measured at current cost, just as under the traditional model.

Debt and equity rates are combined into a weighted average rate using the market values of debt and equity. (This method contrasts with the traditional method, which uses book values as weights). As under the traditional method, the resulting cost-of-capital is applied to a net historical cost investment base.

Real Cost of Capital

The real cost of capital is the nominal cost of capital with the inflation premium removed. Investors are compensated for inflation through measuring the investment base at current value.

RAPB final Report at 34.

8. If investors are fully compensated for the effects of inflation either (1) by applying the nominal cost of capital to historical asset values, or (2) applying the real cost of capital to current asset values, it is clear that applying the nominal cost of capital to current asset values overcompensates investors for the effects of inflation. A simple numerical example may help to make this clear. Consider an example in which an initial investment of \$1,000,000 is made under the following assumptions:

- Economic life is 10 years;
- Nominal cost of capital is 10%;
- Inflation rate is 4%;
- Real cost of capital is 5.77% $((1.10 / 1.04) - 1)$.

9. The alternatives described above lead to two different cost recovery patterns either of which, over the life of the asset, generates a present value equal to the initial investment in the asset.

Figure 1
Alternative Methods of Capital Recovery

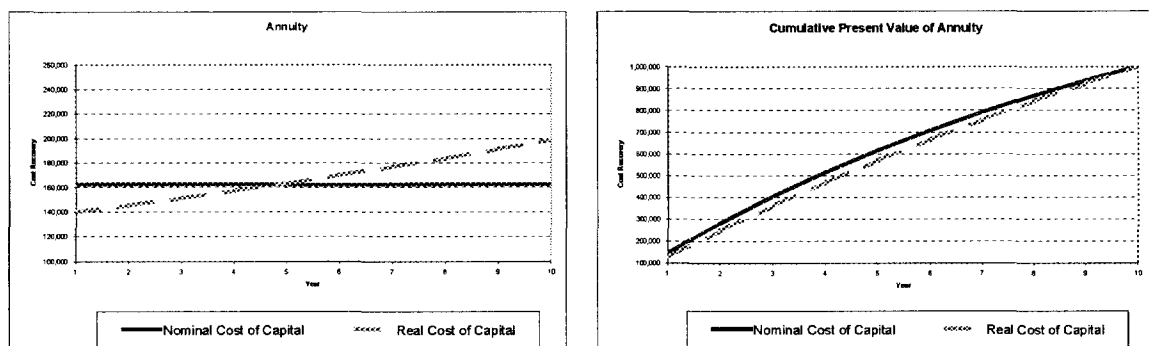
Year	Nominal Cost of Capital					Real Cost of Capital				
	Annuity	Inflation Factor	Inflated Annuity	Present Value Factor	Present Value of Annuity	Annuity	Inflation Factor	Inflated Annuity	Present Value Factor	Present Value of Annuity
1	162,745	N/A	162,745	0.9091	147,950	134,386	1.0400	139,762	0.9091	127,056
2	162,745	N/A	162,745	0.8264	134,500	134,386	1.0816	145,352	0.8264	120,126
3	162,745	N/A	162,745	0.7513	122,273	134,386	1.1249	151,166	0.7513	113,574
4	162,745	N/A	162,745	0.6830	111,157	134,386	1.1699	157,213	0.6830	107,379
5	162,745	N/A	162,745	0.6209	101,052	134,386	1.2167	163,502	0.6209	101,522
6	162,745	N/A	162,745	0.5645	91,866	134,386	1.2653	170,042	0.5645	95,984
7	162,745	N/A	162,745	0.5132	83,514	134,386	1.3159	176,843	0.5132	90,749
8	162,745	N/A	162,745	0.4665	75,922	134,386	1.3686	183,917	0.4665	85,799
9	162,745	N/A	162,745	0.4241	69,020	134,386	1.4233	191,274	0.4241	81,119
10	162,745	N/A	162,745	0.3855	62,745	134,386	1.4802	198,925	0.3855	76,694
TOTAL					1,000,000					1,000,000

10. The above table illustrates that calculating cost by applying the nominal cost of capital to an asset base that is “frozen” at historical levels fully recovers the initial \$1,000,000 investment

over the 10-year period (the costs in the table are calculated as an annuity that, like your house mortgage, covers both inflation and return on investment). The table also illustrates that calculating costs by applying the real cost of capital to an inflating asset base each year at the appropriate inflation rate (the mathematical equivalent of recalculating the annuity each year using the real cost of capital and the inflated asset base) similarly fully recovers the initial \$1,000,000 investment over the 10-year period. Under either approach, the nominal discount rate is appropriate because the cash flows being discounted (shown in the “Inflated Annuity” column) already reflect the effects of inflation in one way or the other. The following chart illustrates these two recovery patterns:

Figure 2

Chart of Alternative Capital Recovery Patterns



11. The inflation double-count inherent in BellSouth’s use of a nominal cost of capital while increasing the per line asset values each year to reflect the effects of inflation on asset and labor unit prices is reflected in the following table.

Figure 3

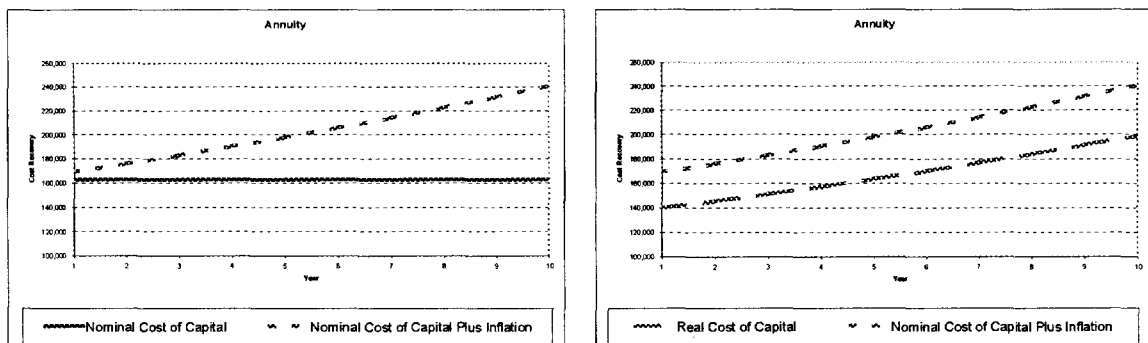
Illustration of BellSouth's Double-Count of Inflation

Year	Nominal Cost of Capital		Real Cost of Capital		Real Cost of Capital				
	Annuity	PV of Annuity	Annuity	PV of Annuity	Annuity	Inflation Factor	Inflated Annuity	Present Value Factor	Present Value of Annuity
1	162,745	147,950	134,386	127,056	162,745	1.0400	169,255	0.9091	153,868
2	162,745	134,500	134,386	120,126	162,745	1.0816	176,025	0.8264	145,476
3	162,745	122,273	134,386	113,574	162,745	1.1249	183,066	0.7513	137,541
4	162,745	111,157	134,386	107,379	162,745	1.1699	190,389	0.6830	130,038
5	162,745	101,052	134,386	101,522	162,745	1.2167	198,005	0.6209	122,945
6	162,745	91,866	134,386	95,984	162,745	1.2653	205,925	0.5645	116,239
7	162,745	83,514	134,386	90,749	162,745	1.3159	214,162	0.5132	109,899
8	162,745	75,922	134,386	85,799	162,745	1.3686	222,728	0.4665	103,904
9	162,745	69,020	134,386	81,119	162,745	1.4233	231,637	0.4241	98,237
10	162,745	62,745	134,386	76,694	162,745	1.4802	240,903	0.3855	92,879
TOTAL		1,000,000		1,000,000					1,211,026

12. Under the assumptions of my hypothetical, the above table shows that under BellSouth's approach, it would over-recover its initial investment by more than 21 percent if it were allowed to use the nominal cost of capital and adjust the per line asset values each of the 10 years for the effects of inflation. The following charts also help to illustrate this point.

Figure 4

Chart of BellSouth's Double-Count of Inflation



13. The above charts show that either (1) use of the nominal cost of capital and the uninflated asset values per line, or (2) use of the real cost of capital and the inflated per line asset

values would be sufficient to allow BellSouth to recover its investment and earn its cost of capital. The Florida Commission's adoption of BellSouth's approach, represented by the short dashed lines, would allow it to recover more than the true economic cost of the asset. The difference between the two sets of lines on each of the above graphs represents the amount of the overstatement.

14. The impact of this double-count -- inflating material prices into the future and including inflation in the cost of capital -- has a significant impact on BellSouth's UNE rates.² The primary reason is that BellSouth's application of inflation to both material and labor dollars is based on outdated inflation statistics, relying on actual data from 1997 and earlier. While the Florida Commission recently acknowledged that BellSouth's inflation data is outdated (and even noted that BellSouth agrees), the Florida Commission has nevertheless chosen to use BellSouth's stale inflation forecasts that significantly overstate inflation in asset prices (largely due to the economic decline).³

15. The extent to which BellSouth's inflation factors overstate investment can be seen by review the inflation factors adopted by the Florida Commission and incorporated into BellSouth's UNE rates (*i.e.*, an inflation factor of 7.68% means that the resulting costs will be overstated by 7.68% for that asset category):

² Specifically, Joe Gillan's late-file hearing exhibit 70 estimated that BellSouth's improper application of inflation resulted in a four percent overstatement of UNE costs. Thus, this error likely accounts for a \$0.41 overstatement of a two-wire loop UNE in zone 1, a \$0.58 overstatement in zone 2 and a \$1.04 overstatement in zone 3. Moreover, this error results in overstatements ranging from \$2.72 to \$6.86 for DS-1 loop UNEs.

³ 120 Day Order, page 113.

Figure 5

Florida Inflation Factors

		<u>Inflation Factor</u>
Poles	1C	7.68
Aerial Ca - Metal	22C	8.22
Buried Ca - Metal	45C	7.15
Conduit Systems	4C	7.00
Intrbld Network - Metal	52C	9.26
Underground Ca - Metal	5C	9.26
Aerial Ca - Fiber	822C	2.01
Buried Ca - Fiber	845C	4.05
Intrbld Network - Fiber	852C	4.05
Underground Ca - Fiber	85C	-
Digital Sub Pair Gain	257C	(2.00)
Digital Electronics	377C	2.01

16. Moreover, the Florida Commission inappropriately reached a determination that triple-counts the effects of inflation for engineering costs. Not only is this portion of investment double-counted by applying inflation both to labor dollars and in inflation, but it is inflated again by applying a separate inflation adjustment to an engineering ratio -- which is multiplied by the already inflated investments. Therefore, the multiplicative property of mathematics dictates that this will apply inflation yet again to the engineering costs.

III. CONCLUSION

17. The cost overstatement resulting from double-counting (and triple-counting) the effects of inflation in the Florida UNE rates translates directly into overstated UNE rates for AT&T and other CLECs.